CHADBOURNE & PARKE LLP

Client Alert

SEC Adopts Final Disclosure Rules Regarding Audit Committee Financial Experts and Codes of Ethics for Senior Executives

A. Introduction

On January 23, 2003, the SEC published final rules that will require companies to include in their annual reports filed with the SEC new disclosures regarding (i) whether at least one "audit committee financial expert" serves on a company's audit committee and (ii) whether a company has adopted a code of ethics for its principal executive officer and senior financial officers.[1] The new rules, which implement Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (SOA), incorporate several modifications of the rules originally proposed by the SEC in October 2002,[2] including a relaxation of the previously defined term "financial expert". The new rules will apply to annual reports filed for fiscal years ending on or after July 15, 2003.

B. Audit Committee Financial Experts

As mandated by SOA §407, the SEC's final rules require companies to disclose in their annual reports filed under the Securities Exchange Act of 1934 whether at least one member of their audit committee is an "audit committee financial expert" and, if not, why not. Although SOA (and the SEC's proposing release) used the term "financial expert", the SEC decided to use the term "audit committee financial expert" in its final rules to clarify that the designated person must have characteristics that are particularly relevant to the functions of the audit committee.

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[1] Securities and Exchange Commission Release Nos. 33-8177; 34-47235; File No. S7-40-02. A copy of the final rule is available on the SEC website at http://www.sec.gov/rules/final/33-8177.htm.

[2] Securities and Exchange Commission Release Nos. 33-8138; 34-46701; File No. S7-40-02. A copy of the proposing release is available on the SEC website at http://www.sec.gov/rules/proposed/33-8138.htm. The proposing release also included requirements relating to internal control reports and auditor attestations of those reports, implementing §404 of SOA. The SEC has stated that final rules implementing SOA §404 will be issued at a later date so as to allow the Public Company Accounting Oversight Board sufficient time to adopt standards for attestation engagements.

Definition of "Audit Committee Financial Expert". The final rules define an "audit committee financial expert" as a person who has all of the following attributes:

- an understanding of GAAP and financial statements;
- the ability to assess the general application of GAAP in connection with accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The audit committee financial expert must have acquired these attributes through any one or more of the following:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.

In response to concerns raised by commenters, the SEC modified its originally proposed definition of "financial expert" in several respects, including:

- requiring "ability", rather than "experience", in applying GAAP to estimates, accruals and reserves, and eliminating the requirement that such ability be specifically related to estimates, accruals and reserves generally comparable to those used in the company's financial statements;

- replacing the proposed rule's requirement for experience "preparing or auditing financial statements" with a less restrictive requirement of experience "preparing, auditing, analyzing or evaluating financial statements" or experience actively supervising persons engaged in these activities;
- omitting a proposed instruction listing factors a company's board should consider in evaluating an individual's education and experience in response to concerns that boards would use the list as a mechanical checklist;
- clarifying that, with respect to foreign private issuers, an audit committee financial expert's understanding must be of the generally accepted accounting principles used to prepare the issuer's primary financial statements filed with the SEC, and not necessarily U.S. GAAP;
- substantially expanding the means by which the individual may obtain the required expertise to include (1) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements and (2) "other relevant experience"; and
- eliminating the proposed requirement that an audit committee financial expert must have gained the relevant experience with a company that was an Exchange Act reporting company at the time the individual held his or her position.

The rules require a company to disclose in its annual report (or in its proxy statement with incorporation by reference into its annual report) that its board of directors has determined that the company does, or does not, have an audit committee financial expert serving on its audit committee. Any company disclosing that it has an audit committee financial expert must disclose his or her name.[3] A company disclosing that it does not have an audit committee financial expert must explain why it does not have such an expert. In addition, companies must disclose whether their identified audit committee financial experts are "independent" under applicable SEC or stock exchange requirements.

[3] The SEC's originally proposed rules would have required companies to disclose the number and names of all persons determined to be financial experts; the final rules more closely track the language used in SOA §407 and permit, but do not require, a company to disclose that it has more than one audit committee financial expert.

Safe Harbor. To address other concerns expressed in numerous comment letters, the final SEC rules also add a safe harbor to clarify that the designation of a member of the audit committee as an audit committee financial expert does not alter the duties, obligations or liability of any audit committee member, including the individual named as an audit committee financial expert.

Companies, other than small business issuers, must comply with the audit committee financial expert disclosure requirements starting with their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply starting with their annual reports for fiscal years ending on or after December 15, 2003.

C. Codes of Ethics for Senior Executives

SOA §406 requires the SEC to adopt rules requiring Exchange Act reporting companies to disclose whether or not they have adopted a code of ethics applicable to their principal financial officer and comptroller or principal accounting officer, or persons performing similar functions. The rules adopted by the SEC extend the scope of SOA §406 by requiring disclosure in annual reports filed under the Exchange Act (or in proxy statements with incorporation by reference into annual reports) of whether or not the reporting company has adopted a written code of ethics that applies to its principal executive officer, as well as its senior financial officers. Companies that have not adopted a code of ethics applicable to these officers must explain why they have not done so.

The rules define a "code of ethics" as written standards that are reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely and understandable disclosure in the company's SEC filings and submissions and other public communications;
- compliance with applicable governmental laws, rules and regulations;
- prompt internal reporting of code violations to an appropriate person or persons identified in the code; and
- accountability for adherence to the code.

The rules do not mandate any specific language for the code of ethics. A new instruction in the final rules indicates that a company may have separate codes of ethics for different types of officers. In addition, the required components of the code of

ethics may be part of a broader code that addresses additional issues and applies to additional persons.

A company that has adopted a code of ethics would be required to make the code publicly available by one of the following methods:

- filing a copy of the code of ethics as an exhibit to its annual report;
- posting the text of the code on the company's website; or
- providing an undertaking in its annual report to provide a copy of the code free of charge to any person upon request.

The second and third alternatives were added in the final rules. The final rules also provide that companies need only file, post or provide the portions of a broader code of ethics (if applicable) that constitute the code required by the rules.

The rules also require disclosure within five business days,[4] either on Form 8-K or on the company's website, of:

- the nature of any amendment to the company's code of ethics applicable to the specified officers; or
- the nature of any grant of a waiver, including an implicit waiver,[5] from a code provision granted by the company to any of the specified officers and the date of the waiver.

In order to use the website disclosure option, the company must have disclosed in its most recent annual report filed with the SEC its website address and that it intends to use its website to disclose these events. The disclosure would need to remain on the company's website for at least 12 months and be retained for at least five years.

Foreign private issuers, who are not required to file current reports on Form 8-K, are required to disclose any amendments or waivers of their code of ethics applicable to the specified officers during the past fiscal year as an exhibit to their annual report on Form 20-F or 40-F. In addition, although not mandated, the SEC strongly encourages foreign private issuers to disclose promptly on Form 6-K, or on their website, any such amendment or waiver.

[4] The proposed rules would have required this disclosure within two business days.

[5] The adopting release defines "implicit waiver" as any failure by the company to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer of the company.

Companies must comply with the code of ethics disclosure requirements in annual reports for fiscal years ending on or after July 15, 2003.

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For Additional Information

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